Supreme Court, U.S.
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No. 98-799

IN THE

Supreme Court of the United States

OCTOBER TERM, 1998

KAUTHAR SDN BHD,

Petitioner,

vs.

MICHAEL A. STERNBERG, *et al.*,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the one-year limitations period established by Section 9(e) of the Securities Exchange Act of 1934 for claims under Section 10(b) of the Act and SEC Rule 10b-5 begins to run when the plaintiff becomes aware of facts that would lead a reasonable person to investigate whether fraud has occurred, or when the plaintiff actually discovers the fraud.

2. Whether the payment of a finders' fee to corporate insiders was sufficiently central to the alleged fraudulent scheme so that notice of the finders' fee was sufficient to place plaintiff on notice of other aspects of the scheme.

3. Whether the court of appeals erred by not remanding the state fraud claims after having affirmed dismissal of the federal claims.

LIST OF PARTIES

The petition accurately lists the parties to the petition.

RULE 29.6 LISTING

Respondents Friendly Islands Satellite Communications, Ltd. and Nilson Research Corporation do not have any parent corporations or nonwholly owned subsidiaries.

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OPINIONS BELOW

The opinion of the court of appeals is reported at 149 F.3d 659 and is printed in Petitioner's Appendix (Pet. App. 1a-30a). The district court's opinions and orders are unreported and are printed in Pet. App. 33a-38a, 39a-59a, 60a-111a, 112a-125a, 128a-129a and 130a-134a.

STATEMENT OF JURISDICTION

The judgment of the court of appeals was entered on July 14, 1998. The court denied a petition for rehearing on August 12, 1998. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATEMENT OF THE CASE

Petitioner brought this securities fraud suit after having lost a $38 million investment in Rimsat, Ltd., a company formed to provide communication satellites to customers in the Pacific Rim region. The complaint included a count under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5. The district court dismissed that count for failure to comply with the one-year limitations period in Section 9(e) of the 1934 Act. 78 U.S.C. § 78i(e). The court of appeals affirmed on the ground that petitioner "was aware of sufficient facts to enable it to learn that it had a cause of action for fraud against the defendants more than one year before it filed suit." Pet. App. 25a-26a.

Central to the fraud charge was petitioner's allegation that a significant portion of the initial investment, instead of being used for constructing satellites or launch vehicles and leasing orbital positions, was diverted to a finders' fee paid to a Hong Kong corporation controlled by one or more insiders. Pet. App.

24a. Petitioner conceded that it had learned of the finders' fee more than one year before suit and had initiated an investigation, but stopped the investigation after receiving a letter dated September, 1, 1993 from Hilliard, one of the insiders and later a defendant, stating that he had not received any monies from the fee. Pet. App. 52a. Petitioner then waited 17 months before filing suit against Rimsat's principals and others in March, 1995, six weeks after a petition placing Rimsat in bankruptcy was filed. Pet. App. 4a. Petitioner claimed that it learned after the bankruptcy filing that Hilliard and other insiders had shared the finders' fee. Pet. App. 54a.

The district court concluded that petitioner had not explained "why, based on Hilliard's letter alone, it decided to halt its investigation, thus ignoring the 'storm warning' that aroused its suspicions." Pet. App. 54a. The court of appeals agreed, pointing out that, as part of the investment agreement, petitioner was represented on Rimsat's Board of Directors and had the power to appoint one half of the directors. Pet. App. 25a. Consequently, petitioner had "ready access to the financial information of the company." *Id.* In these circumstances, the court of appeals concluded, once petitioner learned of the finders' fee, it was "able . . . to ascertain the information needed to file suit," and its "obligation to inquire was [not] satisfied even if one of the defendants told [it] that he had not received any of those diverted funds." Pet. App. 25a and n.15.

ARGUMENT

In *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), this Court held that private suits under § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 are subject to the federal statute of limitations in § 9(e) of the Act. Section 9(e) provides that suit must be brought "within one year after the discovery of the facts constituting the violation and within three years after such violation." 15 U.S.C. § 78i(e).

After *Lampf* was decided, the courts of appeals of six Circuits — the Second, Fourth, Fifth, Seventh, Eighth and Tenth — applied the so-called "inquiry notice" standard to Section 9(e). Cases cited at Pet. 14-15. Under this standard, "discovery" takes place when the plaintiff receives either actual knowledge of facts giving rise to the action "or notice of the facts, which in the exercise of reasonable diligence, would have led to actual knowledge." *Menowitz v. Brown*, 991 F.2d 36, 41-42 (2d Cir. 1993), quoting *Kahn v. Kohlberg, Kravis, Roberts & Co.*, 970 F.2d 1030, 1042 (2d Cir.), *cert. denied*, 506 U.S. 986 (1992). No court of appeals has held that Section 9(e) requires actual knowledge of the facts giving rise to the action.

In the court of appeals, petitioner's only argument on the statute of limitations issue was that the facts alleged in the complaint were not sufficient to establish inquiry notice prior to the limitations period. In this Court, however, petitioner raises for the first time the issue of whether actual notice rather than inquiry notice is required to start the one-year limitations period.

1. It is only in "exceptional cases" that this Court reviews "questions not pressed or passed upon below." *Duignan v. United States*, 274 U.S. 195, 200 (1927). The present case is not "exceptional." The inquiry notice issue is not jurisdictional, is not a predicate to any constitutional issue in the case, does not constitute "plain error," and implicates none of the other reasons justifying a departure from the normal rule that "this Court does not decide questions not raised or involved in the lower court." *Youakim v. Miller*, 425 U.S. 231, 234 (1976); *Breininger v. Sheet Metal Workers Intern.*, 493 U.S. 67, 94 (1989). *See* Stern, Gressman *et al.*, *Supreme Court Practice* (7th ed.) at § 6.26.

2. In any event, the decision below was correct. In *Lampf*, this Court held that the limitations period in Section 9(e) of the Securities Exchange Act of 1934 governs private securities fraud claims under Section 10(b). Section 9(e) provides that the limitations period is one year after "discovery of the facts constituting the violation." 15 U.S.C. § 78i(e). Since *Lampf*, the courts of appeals have unanimously held that "discovery" under Section 9(e) includes "constructive and inquiry notice as well as actual notice." *Dodds v. Cigna Securities, Inc.*, 12 F.3d 346 (2d Cir. 1993), *cert. denied*, 511 U.S. 1019 (1994); *Howard v. Haddad*, 962 F.2d 328 (4th Cir. 1992); *Topalian v. Ehrman*, 954 F.2d 1125, 1133 (5th Cir.), *cert. denied*, 506 U.S. 825 (1992); *Tregenza v. Great American Communications Co.*, 12 F.3d 717 (7th Cir. 1993), *cert. denied*, 511 U.S. 1085 (1994); *Anixter v. Home-Stake Production Co.*, 947 F.2d 897 (10th Cir. 1991), *vacated on other grounds, sub nom. Dennler v. Triplett*, 503 U.S. 978 (1992).

These decisions accord with a long line of pre-*Lampf* cases under both state and federal statutes. Under Section 29(b) of the 1934 Act, which provides — in language indistinguishable from Section 9(e) — that suit must be brought "within one year after the discovery that such sale or purchase involves such violation,"[1] the Fifth Circuit has held that

> "[d]iscovery" . . . is to be determined . . . according to an objective standard; that is, "discovery" means either actual knowledge or notice of facts which, in the exercise of due diligence, would have led to actual knowledge of the violation.[2]

Several cases have held that inquiry notice is sufficient to start the limitations period running under state statutes requiring

1. 15 U.S.C. § 78cc(b).

2. *Goldenberg v. Bache and Company*, 270 F.2d 675, 681 (5th Cir. 1959).

"discovery by the aggrieved party of the facts constituting the fraud"[3] or "discovery of the fraud"[4] — language indistinguishable from the formulation of Section 9(e) ("discovery of the facts constituting the violation"). There are no contrary decisions under Section 9(e).

The case law adopting the inquiry notice standard stems from decisions antedating the 1934 Act. In *Curtis v. Connly*, 257 U.S. 260, 264 (1921), this Court applied inquiry notice under a state statute providing that a fraud action accrues when the plaintiff "shall first discover its existence."[5] And in *Bailey v. Glover*, 88 U.S. (21 Wall.) 342, 349 (1874), the Court announced that it would construe federal statutes of limitation in light of the general equitable principle that a cause of action for fraud does not begin to run until the fraud is discovered

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3. *Busenius v. Horan*, 769 P.2d 869, 872 (Wash. App. 1989), applying Wash. Rev. Code § 4.16.040; *Hilton v. Mumaw*, 522 F.2d 588, 595 (9th Cir. 1975) (also applying Washington statute); *Koulis v. Standard Oil Company of California*, 746 P.2d 1182, 1185 (Utah App. 1987), applying Utah St. § 78-12-26(3); *North Carolina National Bank v. Carter*, 322 S.E. 2d 180, 184 (N.C. App. 1984), applying N.C. Stat. § 1-52(9); *Turley v. Turley*, 649 P.2d 434, 440 (Sup. Ct. Mont. 1982), applying MCA § 27-2-203; *Stafford v. Mississippi Valley Title Insurance Co.*, 569 So. 2d 720, 724 (Sup. Ct. Ala. 1990); *Sexton v. Liberty National Life Ins. Co.*, 405 So. 2d 18, 20-21 (Sup. Ct. Ala. 1981), applying Ala. Code 1975 § 6-2-3.

4. *A.C. Heise v. Pilot Rock Lumber Co.*, 352 P.2d 1072, 1079 (Or. Sup. Ct. 1960), applying Or. St. § 12.110; *Jennings v. Jennings*, 507 P.2d 241, 249 (Sup. Ct. Kan. 1973), applying K.S.A. § 60-513; *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168, 171 (10th Cir. 1974), relying on *George H. McFadden & Bro., Inc. v. Home-Stake Production Co.*, 295 F. Supp. 587, 589 (N.D. Okla. 1968) (quoting Oklahoma statute).

5. *See also Tregenza v. Great American Communications Co.*, 12 F.3d 717, 722 (7th Cir. 1993), *cert. denied*, 511 U.S. 1085 (1994), discussing other Supreme Court decisions.

"when there has been no negligence or laches on the part of a plaintiff in coming to the knowledge of the fraud."

Petitioners argue that *Lampf* requires a contrary result. However, *Lampf* merely decided that Section 9(e) applies to claims under Section 10(b). The Court did not discuss how Section 9(e) should be interpreted. Petitioner quotes the Court's statement that under Section 9(e) the action must be commenced within one year of "discovery of the facts constituting the violation." *Lampf*, 501 U.S. at 364. But that statement merely tracks the statutory language, without discussing what constitutes "discovery." Nor did the Court give any indication that it intended to overrule the substantial body of law interpreting statutes with identical language to incorporate the inquiry notice standard.

Petitioners argue that Section 9(e)'s failure to include explicit language incorporating an inquiry notice standard must be taken as rejection of that standard, because Section 13 of the 1933 Act includes such explicit language. 15 U.S.C. § 77m. However, when Congress passed Section 9(e) in 1934, it did not know that later judicial construction would apply the statute to fraud claims; the explicit terms of the statute apply to claims of manipulation of prices on a national exchange or violation of SEC rules on puts, calls, straddles or options. 15 U.S.C. § 78i(e). Thus Congress had no reason to address the issue of inquiry notice in fraud cases, and no inference can be drawn from its silence. And in any event, Congress had every reason to believe that, if the statute were judicially extended to fraud claims, the inquiry notice standard traditionally applied by the courts to such claims would govern. *Bailey v. Glover*, *supra*; *Curtis v. Connly*, *supra*. By contrast, Section 13 expressly applies to fraud claims,[6] and thus Congress had a good reason to address the inquiry notice issue expressly.

6. Section 13 applies to liability for false registration, and for sale of securities by use of false or misleading prospectuses or oral statements. 15 U.S.C. § § 77m, 77k, 77*l*(2).

Petitioners argue that the inquiry notice standard has been inconsistently applied, citing the Tenth Circuit's decision in *Sterlin v. Biomune Sys.*, 154 F.3d 1191 (10th Cir. 1998). But the only inconsistency identified by the Tenth Circuit relates to the issue of whether the statute begins to run on "the date Plaintiff was allegedly placed on inquiry notice" or on "the date Plaintiff claims he could reasonably have discovered the facts underlying the alleged fraud." *Sterline*, 154 F.2d at 1201. That narrow issue regarding the interstices of the inquiry notice standard is far different from the "inquiry notice" vs. "actual notice" issue which petitioner attempts to raise for the first time in this Court. Petitioner never argued that, once having been placed on notice of the finders' fee 17 months before filing suit, its representatives on the company's Board of Directors could not have discovered within less than five months the remaining pertinent facts. There was ample basis for the court of appeals' conclusion that petitioner "was aware of sufficient facts to enable it to learn that it had a cause of action for fraud against the defendants more than one year before it filed suit." Pet. App. 25a-26a.

Finally, petitioners argue that the decision of the court below will place investors under compulsion to investigate and sue upon "the slightest irregularity in the performance of his or her investment." Petition at 16. That is a gross exaggeration. The inquiry notice standard was the prevailing rule for many years. It was applied by the federal courts that borrowed state statutes of limitation for § 10(b)(5) claims before *Lampf*.[7] The

7. The pre-*Lampf* decisions borrowing state statutes of limitation for § 10(b) claims applied federal law to determine the date on which the statute of limitations begins to run, and held that "[u]nder federal law a statute of limitations begins to run 'when the fraud is or should have been discovered,' " with the plaintiff having "a positive duty to use diligence in discovering the existence of a cause of action." *Herm v. Stafford*, 663 F.2d 669, 682 (6th Cir. 1981), quoting *Vanderboom v.* (Cont'd)

two Circuits that applied a federal statute of limitations before *Lampf* did so for only a brief period, having previously also applied state limitations periods to § 10(b) claims in conjunction with the federal notice inquiry standard.[8] Thus before *Lampf* the notice inquiry standard prevailed. And, as petitioners concede, the notice inquiry standard has also been applied by the six Circuits that have considered the issue post-*Lampf*.[9] If the notice inquiry standard were to produce the "race to the courthouse" predicted by petitioners (Petition at 17), such a stampede would have been evident by now. In fact, of course, none has materialized.

As the Seventh Circuit pointed out, jettisoning the inquiry notice standard would mean that investors typically could wait for the full three-year period of repose before suing. Yet "[t]hree years is an age in the stock market." *Tregenza v. Great American Communications Co.*, 12 F.3d 717, 722 (7th Cir. 1993), *cert.*

(Cont'd)
Sexton, 422 F.2d 1233, 1240 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970); *Arneil v. Ramsey*, 550 F.2d 774, 780-81 (2d Cir. 1977).

8. Before *Lampf*, only the Third and Seventh Circuits applied federal periods of limitation to § 10(b) claims. These Circuits adopted that rule only a few years before *Lampf*, in each case overruling prior Circuit precedent applying state limitations periods. *In re Data Access Systems Securities Litigation*, 843 F.2d 1537 (3d Cir.) (en banc), *cert. denied*, 488 U.S. 849 (1988); *Short v. Belleville Shoe Mfg. Co.*, 908 F.2d 1385 (7th Cir. 1990), *cert. denied*, 501 U.S. 1520 (1991). The prior Circuit precedent had held that federal law determined when the state period of limitation starts to run, and under federal law the period starts to run when the plaintiff should have discovered the facts. *Biggans v. Bache Halsey Stuart Shields*, 638 F.2d 605, 607 n.3 (3d Cir. 1980); *Tomera v. Galt*, 511 F.2d 504, 509-10 (7th Cir. 1975) (stating that actual discovery is required only where the defendant has taken positive steps to conceal the fraud).

9. *See* Cases cited in Petition at 14-15.

denied, 511 U.S. 1085 (1994). Routinely allowing investors three years to sue, even where they know something might be wrong and have the means to investigate, would encourage

> the opportunistic use of federal securities law to protect investors against market risk. . . . If the stock rebounded from the cellar they would have investment profits, and if it stayed in the cellar they would have legal damages. Heads I win, tails you lose.

Id. There is no reason to believe that Congress intended Section 9(e) to encourage this tactic by altering the standard that has traditionally been applied by federal and state courts in both securities and non-securities fraud litigation.

3. Petitioner argues that even if it was on notice of the diversion of funds to insiders through a finders' fee, there were other unrelated aspects of its fraud claim as to which it was not on notice. However, in the district court petitioner "stresse[d] that the [finders' fee] is, in its view, a critical component of the fraud that it is trying to establish." Pet. App. 52a. The court of appeals agreed, concluding that petitioner's knowledge of the finders' fee and its position on the company's Board of Directors should have been sufficient to prompt an investigation of the entire matter. There is no occasion for this Court to review the conclusion of the courts below on this essentially fact-specific issue.

4. Finally, petitioner argues that the court of appeals should have let its state-law claims go to trial, even if its federal claims were properly dismissed. However, nowhere in its brief before the court of appeals did petitioner argue for separate treatment of its state claims, other than in a footnote referring to a trial

court brief on the issue. As the court of appeals correctly ruled with respect to another such instance in petitioner's brief in the court of appeals a footnote in an appellate brief referring to a trial court brief is not sufficient to preserve an issue for appellate review. Pet. App. 19a.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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